National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

HC 290
SESSION 2010–2011

21 JULY 2010

Ministry of Defence

Strategic Financial Management of the Defence Budget

Summary

Scope of the NAO examination

1 The Ministry of Defence (the Department) is one of the largest spending departments, responsible for over £42 billion of expenditure. Defence needs effective financial management to direct and control its resources to deliver its aims and objectives within its budget. While the size of the future deficit is highly sensitive to the budget growth assumptions, in December 2009 we reported a shortfall between the estimated budget and the cost of the forward defence spending programme that ranges from £6 billion to £36 billion over the next ten years.

2 In May 2010, the Government announced a Strategic Defence and Security Review to be completed by the end of the year. Central to this review is the issue of reducing the shortfall and restoring balance to future defence spending. Of equal importance is ensuring that the Department is able to maintain this balance in the future and prevent a recurrence of the present situation. This report will consider whether the Department's approach to financial management will be sufficient to achieve this objective.

3 The Defence environment is complex and presents the Department with a range of challenges to its financial management from both external and internal factors. The main emphasis of this report will be to focus on internal factors which are more amenable to management by the Department. If the Department manages its finances well, it should be better positioned to respond to external challenges.

4 The Department's Resource Accounts 2008-09 were qualified on several bases, which included errors in military specialist pay and allowances, the income recovered from military personnel for certain accommodation and food, and the existence and valuation of some stock and fixed assets. Our work in 2009-10 indicates the Department has made improvements, but that some of the issues remain. This report presents the findings and recommendations from our examination of the Department's strategic financial management of the defence budget in three parts:

- Part One: the role of the Department and its impact on financial management;
- Part Two: defence spending and cost drivers; and
- Part Three: the strategic planning processes.

Key findings

The Department faces a number of challenges due to the nature of the defence environment

5 **The Department has been operating above the level of activity for which it is routinely resourced and will have additional funding for Iraq and Afghanistan withdrawn when these operations end.** The last exercise wholly to reset the policy baseline for defence was the 1998 Strategic Defence Review. This exercise was updated in 2002 and 2004. Since 1998 the Department has responded to tensions that have arisen between the spending plans set by these assumptions, the changing priorities and the available funding, by continuously reprioritising planned expenditure. When current operations end, if the Department wishes to retain any of the additional equipment acquired for operations, it will have to fund the costs of repair and support from within its core budget.

6 **The growth in the input costs of defence has been more than general inflation.** Inflation in defence costs is estimated by the Department to have averaged 3.8 per cent over the last four years[1], which is 1.2 percentage points higher than the GDP deflator[2], HM Treasury's measure of general inflation in the domestic economy and between 0.4 – 1.1 percentage points higher than a range of general inflation indices.

7 **The Defence plans require a longer horizon than Government spending plans and are relatively inflexible.** Long timescales are required to develop and field modern military capabilities with defence plans extending up to 20 years when compared against typical spending reviews at two to three year intervals. Decisions taken at any given point in time create long term commitments and liabilities, with up to 75 per cent of the budget committed in the next financial year to long term capabilities and people, reducing gradually thereafter.

8 **There are a number of other influences in the Defence environment which have affected the Department's plans over time.** The last full Strategic Defence Review was in 1998 and some of the issues we refer to in this report have built up over the following years. The Department considers that, in the absence of a Defence Review, although its financial planning rounds had identified shortfalls between forecast expenditure and budgeted provision, some of the measures that could have reduced costs, but would have had an adverse impact on longer term Defence capability, could not be agreed within Government. The Department's ability to react has also been constrained by industrial policy and commitments arising from international alliances.

The Department could use financial management more effectively to address those factors that are within its control

9 **The outcome of the Department's annual planning rounds contributed to significant in-year budgetary pressure.** By the end of July 2009, the budget for the Department was exceeded by its forecast for the rest of that year by £700 million (around two per cent of the total defence budget). At the end of the 2010 planning round, the Department forecast a shortfall of £185 million between planned expenditure and budget for 2010-11. When the operational budget holders reassessed the assumptions underlying the plan, they forecast the deficit as more than £500 million.

10 **Although the Department uses the planning round to set strategic priorities, it has not routinely prioritised individual elements of its spending programme.** As a consequence, it does not have a straightforward basis to determine which areas of expenditure should receive priority when budgets are insufficient to fund all previously planned activities.

11 **The Department would find it easier to prioritise and find efficiencies if it had better visibility of its costs.** Each year the Department carries out work to analyse its overall cost base. It has an understanding of the component parts, such as fuel costs and salaries, although it needs to develop this further, particularly for cross-cutting activities, outputs, and the total cost of capabilities.

12 **The Department could place greater focus on the extent to which its assets are used efficiently.** To date, the Department's financial plans have been based only on the control total funding regime set by HM Treasury which does not place a focus on the size of asset holdings, for example stock levels. Consequently, there may be scope to realise savings from efficiencies in relation to asset holdings.

13 **The Department has some of the financial management capabilities it needs but could use them more effectively.** The Department now has a professionally qualified Finance Director, who is a member of the Defence Board. However, the Director General for Strategy leads on strategic aspects of financial planning, while the Director General for Finance provides advice on the financial coherence of the emerging plans, risk and contingency. We understand that the Department's rationale for this arrangement included workload, particularly during a Strategic Defence and Security Review, but we take the view, in line with HM Treasury guidance, that this is undesirable as it reduces the authority of the Finance Director.

Over-committed plans have significant consequences

14 **At the end of the last two spending rounds, the Department's over-committed plans have led to budgetary pressure in the new financial year. This has led to additional savings being necessary.** During 2009-10 the Department had to find additional savings of £800 million in year to bring its planned expenditure back into line with its budgets. Finding further savings mid-year is a time-consuming and de-stabilising exercise. Many areas have to revisit or adjust their plans leading to delays, material changes to project specifications, and costly renegotiation of contracts with industry.

15 Delaying projects leads to significant increases in costs. In December 2009 two-thirds of the gross cost increases reported in the Major Projects Report reflected deliberate decisions to slip projects, in particular the new aircraft carriers. The decisions were taken corporately by the Department as part of a wider package designed to address a gap between estimated funding and the cost of the Defence budget over the next ten years.[3]

The Department has started to take action to improve financial planning

16 The Strategy for Defence published in October 2009 helped to set out key priorities by identifying success in Afghanistan as the main effort. In support of this aim, additional funding equivalent to approximately one per cent of the annual defence budget has been found from within the existing defence budget for each of the next three years. To make these additional funds available, in addition to finding efficiencies, the Department chose to delay some spending on new capabilities, to close bases early, and to accept some short-term restrictions on its ability to conduct contingent operations.

17 The Department is introducing new governance arrangements, planning tools and systems to improve strategic financial management. In November 2009 it introduced a new sub-committee of the Board looking at the overall planned expenditure on the equipment plan and the relative priorities between the programmes and projects. Other initiatives include work to improve forecasting, to introduce a new strategic planning tool, to hold an external audit of the affordability of the defence equipment plan, and to improve performance monitoring. These initiatives, if implemented rigorously, should assist the Department in having a more realistic set of financial data on which to make better informed decisions.

Conclusion on value for money

18 There have been improvements in financial management in the Department; however we consider that it still does not place financial management at the heart of its decision making. While the Department operates in a constrained and complex environment and there are factors which are not of its own making that have led to its plans being over-committed, in our view the Department has given insufficient weight to sound financial management practices in setting its budgets and priorities. The Department's finance function does not have as central a role in strategic planning as it should, and financial management does not have a high enough priority to counter the tendency to make over-commitments in its strategic planning.

19 The Strategic Defence and Security Review will provide an opportunity for the Department to rebalance its future spending plans in the short term. Over the longer term, however, the challenge for the Department will be to ensure that these plans remain in balance. Perpetuating the cycle of over-committed plans, short term cuts and re-profiling of expenditure, would mean the continuation of poor value for money for the taxpayer on the projects affected and a reduction in the funds available to support front line activities.

20 Value for money will be improved in the long term principally by making future plans deliverable and through strong governance of the planning process. The Department can show it is determined to achieve this outcome by making maintenance of a balanced forward programme a primary objective of its plans. The most effective tool at its disposal to do this is its finance function, which should be supported by active sponsorship from the Defence Board. The Department has work under way that should make financial planning more effective, but it also needs to demonstrate that it has the will to use the tools it already possesses.

Recommendations

21 The National Audit Office makes the following recommendations:

a **The Department should use the Strategic Defence and Security Review to rebalance its programme and take action to keep it in balance for the future. The Department should:**

- underpin the Strategic Defence and Security Review with an explicit financial strategy;
- set out the relative priorities of expenditure;
- regularly review performance against financial plans; and
- reprioritise funds to keep the programme in balance without using delays and de-scoping projects as the default approach to reducing expenditure.

b **The financial strategy should be reflected in financial plans prepared by the Department. The Department should make sure that the plans:**

- articulate and review spending priorities annually;
- revisit at least annually the assumptions that underpin the financial plans;
- contain adequate financial provision for risk and to counter optimism bias; and
- consider changes to the assets held and not just the HM Treasury control regime.

c **The Department should use the financial capability it has to best effect and enhance its capability further. The Department should:**

- use professionally skilled finance staff to develop the long term financial strategy and associated risk management strategy;
- drive out the culture of optimism bias that fails to recognise the full cost of projects; and
- enhance visibility and understanding of the cost of delivering outputs and cross-cutting activities.